TRANSCRIPT
PENSIONS FOR PURPOSE PODCAST – SERIES 1, EPISODE 9
THE IMPACT OF IMPROVED FUNDING LEVELS ON PENSION – WITH CHARLOTTE MOORE, DAVID BROWN, PAUL KITSON AND BEN GRAINGER

Charlotte Moore: Hi, welcome to the latest edition of the Pensions for Purpose Podcast. I'm your host, Charlotte Moore, and I'm delighted to welcome you back to the show. David Brown, Senior Director for Pensions for Purpose. Welcome, David.

David Brown: Thank you, Charlotte Moore, and good morning.

Charlotte Moore: We are both delighted to welcome to the show Paul Kitson, UK Head of Pensions Consulting at EY, and his colleague, Ben Grainger, a Partner at EY. Welcome, Paul and Ben.

Paul Kitson: Thank you, Charlotte. Fantastic to be here!

Ben Grainger: Yeah, thanks Charlotte. Great to be on this show!

Charlotte Moore: Today, we're going to be talking about one of the most significant trends to affect the UK pensions industry in recent years: the impact of improved funding levels on pensions and the consequent buyout boom. We're going to be discussing how those insurance companies gaining assets from closed private DB funds are investing them sustainably, and we're going to kick off our questioning with a question to Paul. If you can tell us what is driving this flood of assets out of closed private sector DB schemes, and how many assets do we think we'll be transferring in coming years?

Paul Kitson: Yeah, thank you, Charlotte. It's a great question. So yeah, you're right, you mentioned already that we are seeing a flood of UK private sector DB pension funds looking to move to insurance and looking to move to buyouts. The big driver of that has been the Government bond yield changes that we saw after the Truss mini-budget in 2022. So, although a lot of the headlines were all about the LDI crisis, and of course that was an issue, there were some stresses on the LDI market. Actually, the big news story that really flowed from that, because of the way we mark liabilities in pension funds, was the funding levels for most UK DB pension plans dramatically improved, and that turned what already was a quite healthy market, a number of tens of billions coming from pensions to insurance, into, as you say, an even more active market.

Latest estimates suggest that those numbers might be increasing to record volumes: so, maybe £60 billion of UK pension fund liabilities looking to move from pensions land to insurance, but with several new entrants joining, and albeit there are some constraints on the amount insurers can write in any one year, you know, one can see that increasing further, potentially in future years maybe even up to £70, £80 billion, let’s see.

I think the other important thing to call out in relation to this question, Charlotte, is that as pension funds are arriving at this buyout position, they are there with many more illiquid assets or assets that need a home. That again, is a function of what we saw in 2022. So, as we saw government bond yields increase, the value of the schemes' assets for many things, like government bonds fell, whereas actually the value of their illiquid assets, private markets, infrastructure and other things, actually stayed relatively stable. So, what that meant is, although pension funds intended to only have, you know, maybe five, 10, maybe up to 20-30% of those assets, in most cases, the actual value of them increased as a percentage of the

overall asset base a lot, as other assets were falling, but those stayed stable. We have this kind of interesting phenomenon right now, where we've got a lot of pension funds looking to move across to insurance, but also arriving at that decision with a much higher proportion of illiquid assets than perhaps they might have thought.

Charlotte Moore: Yeah, the one key portfolio scenario that you've described so well. Ben, can you talk to us about how those insurance companies when they receive those tens of billions of assets are thinking about investing them sustainably, and maybe discuss with us, what are the regulatory constraints shaping how they invest, and what the implications are of that?

Ben Grainger: Sure, I'll start with tackling the second half of that question, and it should lead into the first nicely. So, when insurance companies take this £60 billion of assets coming over to back the liabilities, which Paul described, they need to invest them in such a way that meets the Solvency UK matching adjustment requirements, and what that sort of means in a nutshell is that they all have to be credit, pretty much all need to be investment-grade, there's a few wrinkles around that, all need to be genuinely long-term assets. So, they hold to maturity with very limited borrower optionality, and that is quite different to the sort of the breadth that pension funds are able to invest in. So, to an extent that constrains the ability for insurance companies to invest in a way that funds the transition, and in a sustainable way, in the same way that pension funds have done. I think the key difference there is it's very difficult for an insurance company to invest in equity. It's not impossible, but it's very difficult to invest in equity.

A lot of technologies out there to fund the transition, by definition need, to be equity investments, because they're risky is probably not the right word, but they are new and innovative, and require sometimes speculative capital.
So instead, insurance companies would position themselves as a long-term lender, but have a strong eye on sustainability, which is key as a long-term investor, because this is where the world's going right?! If you don't invest sustainably your asset is not going to be worth very much in 20 years' time and so on.

Insurance companies are sort of posed with a bit of a problem almost, in that, they have got 60 billion of assets coming over this year, as Paul said. Roughly speaking, half of those will be invested in public credit and government bonds because they need a level of liquidity, but the other half are out there who is sort of private market investments and loans and there are not nearly enough loans in the UK market available for insurance companies to invest in.

Yet, as Paul said, we have got the private market investments that pension funds are made of which are forming decent size portfolios, but they don't meet their criteria for insurers to invest in, which gives us a challenge to work through.

Charlotte Moore: Ok, that's great. That's very beautifully explained. Thank you, Ben. David, can you give us an indication of what concerns pension schemes have about selecting a buyout provider around sustainability, especially given how regulatory environment is shaping those investments?

David Brown: Yes, absolutely Charlotte. I think it's an important question to ask, because in short, trustees of pension schemes need to be sure that members and dependents' pensions are paid in full. It's one of their key fiduciary duties to make sure that all pensions are paid in full. These pensions are going to continue well into the second half of this century, and long after in many countries' net-zero targets, in 2050.

So during this podcast, we've touched on already the capital requirements insurers are obliged to meet, but alongside this, trustees are increasingly considering sustainability issues, such as climate change and biodiversity loss when considering which insurer to transact with for buyout. But before going on to these considerations, I think it's just worth taking a step back for a moment and thinking about where schemes are today. As Paul has already mentioned, we've got very healthy funding positions for many schemes and that's a great position to be in, but there are challenges for schemes, the first being: the size of the scheme. The size of the scheme is important for smaller, defined benefit schemes, and many of the remaining 5,000 private sector defined benefit schemes are small, they will have problems, if they've invested sustainably up until now to actually have these sustainable investments continued in the future with a buyout insurer. Why would that be? That's because for the smaller transactions, insurers are typically looking for cash. They're less interested in interspecies transfers. So I could be selling sustainable investments today, as a trustee of a small scheme for cash to then be invested in the future in the ways that Ben actually outlined.

Now, this is less of an issue for larger schemes where the selected insurer might be willing to take on interspecies assets, including those private assets that have already been mentioned by Paul. It's also worth flagging up, the second thing I wanted to flag is that for some schemes, there's increasing focus in the industry now about runoff, as opposed to buyout. Runoff involves the opportunity to use that service we've heard about to maybe fund higher employer DC contributions, benefit augmentations: whether that be a discretionary pension increase and also sustainable investing. But putting runoff to one side for a moment, having decided to transact through a buyout, sustainability is one of the many factors for trustees to consider.

Now there are many others, I'm only going to mention them very briefly here, because we might come back to this in a moment, but price is always going to be important for trustees and sponsors alike, albeit with the healthy funding positions today, may be a notch lower than what it has been, and lending more weight to other considerations in the future. The ease of contracting with the insurer is also important, because there's a lot of project management involved around the investments, around data and around payroll. There are factors to consider around the operations, actually holding scheme data, paying pensions.
David Brown: and also communication with members.

Finally, also the strength of the insurer, because there are differences in financial strength for the insurers, and that will also be taken into account and of course, sustainability, which is what we're really wanting to talk about and focus on today. So, as I've already mentioned buyouts are long term in nature, and so systemic risks, such as climate change and biodiversity loss are really important. Insurers will be investing as universal owners over the longer term, insurers will not be able to insulate themselves from these systemic risks. As this is recognised by insurers. There are differences amongst them that trustee advisors can draw out. So, typically the areas that I see trustees and advisors probing from insurers are such as: An insurer’s net-zero objective in place. Is the insurer a UN PRI signatory? Perhaps the insurer could be a stewardship-code signatory, or making progress to being a stewardship-code signatory?

Also, factors such as are they a supportive Climate Action 100 or Nature Action 100. So, really key to take these factors into account, but also not losing sight, where the assets are invested today. So, notwithstanding the restrictions that Ben’s taken us through already. Where are they physically investing the assets today? Are there good examples of sustainability in their current portfolio? At the end of the day any good investment consultant, or buyout provider that might be bought in for these types of transactions that has strong ESG credentials can really help the trustees on this journey.

Charlotte Moore: Thank you for that incredibly complete answer, David. I want to turn my attention back to Ben, because I think we've got a really clear picture now of actually quite how constrained insurance companies are in terms of having to focus only on credit, as you say, a little bit in sovereigns and their choice is either public or private. So, could you tell us, what are the kind of sustainable assets that appeal to these insurance companies, given those constraints around an annuity business?

Ben Grainger: Sure, there's this sort of as an easy end of things like nothing's easy for an insurance company, but easier where they can provide long-term financing to sustainable. So, putting a long-term loan into a wind farm, for example, insurance companies like doing that. There's the other angle, where there's less funding the transition, but ensuring that they are funding businesses that behave in a sustainable and appropriate way. When they're lending against real estate, ensuring that those real estate projects and operations are meeting the targets they should do. There is some power in being a lender in these situations. We've seen examples where loans are built in with interest credits, for doing the right behaviours and hitting the targets. So that the board are remunerated and motivated to make the right decisions on almost a day-to-day basis, because if they don't, then we pay more interest, a little bit more sort of stick than carrot there, a good example of how they can influence.

Then there's the harder way that they would like to be able to do this, but it's difficult. If we look at some of the equity investments that pension funds are able to make, where they're less constrained in the shape of the cash flows, they're all able to invest in. If those projects or equity investments could be structured and transformed into such a way that creates a slice, or usually a senior slice that insurance company can invest in. Then, either finding somewhere else on their own balance sheet, which is possible, but tricky or ideally, on someone else's balance sheet to fund the rest, so ideally they partner up as a senior investor in a sustainable project, where another investor who is less constrained. Maybe a big pension fund can take the rest is where we're sort of seeing the more innovative investments being made.

Charlotte Moore: Yeah, because my understanding, correct me if I'm wrong. But these matching asset compatibility, restraints, and all the rest of it shaping that, that's very applicable to the annuity business that this sits in. But an insurance company has lots of different businesses, and it also has its cash surplus if I'm correct. So maybe part of the risky part could sit with the cash surplus, and then the non-risky bits sit with annuity business. Is that what you're talking about?

Ben Grainger: So yeah, that's what I'm talking about when they do it themselves. I guess when they do make investments of that structured form themselves, and they hold the whole thing on their balance sheet it is possible, but it requires a lot of regulatory approvals. I mean we've seen firms do that to take them up to four years to get it by the regulator, and probably the quickest turnaround time is more like two. So they can't do it, but they're probably only going to be working on one project at a time, and it's usually their most important project. So the external version where someone else replaces the surplus assets will allow that to happen a lot quicker and in a much larger scale across lots of insurers.

Ok, do you think there is a potential conflict brewing in the future between many insurance companies, quite aggressive net-zero targets and the regulatory restraints that they face? Is that going to create a clash? Or can they work within that regulatory environment and still hit those targets? I don't think there's a conflict there. I think they can work within the constraints to meet the targets. I think the conflict more comes from ensuring that all the good work that pension funds have done to fund the transition isn't lost when we transfer this sort of trillion

plus assets and pension funds to insurance companies. So it is not really a rate conflict, but we don't want all that good work to be wasted.

Charlotte Moore: Yeah, and I think David touched on that very well, because you know, that's going to become a sustainability issue for pension schemes. To bring Paul back into the conversation, he's been waiting very patiently. Can you give us an indication of the opportunities there might be in this great asset transfer for asset managers? Is everything going to be managed in-house by insurers? Or can asset managers work with insurers on some of these projects?

Paul Kitson: Yeah, a hundred percent, Charlotte. I think, almost taking on from where Ben Grainger left off, this could be a great opportunity for asset managers to help manage this. The move from pensions to insurance in a way that doesn't disrupt the assets as much as possible, and as Ben Grainger says, to kind of keep that sort of good forward momentum, I think we have in the pension space. I think there is a role for asset managers in that. So we know, for example, that DC pension funds, for example, are looking to scale up in this area. We had the Mansion House DC Compact, which is all about, 11 of the big pension providers getting more into private assets in particular VC. But also other kind of private assets. So I think there is a potential opportunity here for asset managers to perhaps build on some of that role, as the transition happens from pensions to insurance. How might they be able to sort of slice these assets up, or to help generate and make the market for these assets, so that that transition is as seamless as possible?

People aren't just selling everything into cash, and then the insurers are rebuying again, and we have to start that journey. I think the other point worth touching on, is the great one that David mentions, which is ‘run on’ - a very real theme at the moment, a number of DB pension funds are thinking about that, and again, there's a big role for asset managers, therefore in those funds. Either they're going to run on more generally, more long term, and they think about their assets and the purpose within their assets, but also even those that want to get to buy out. I mean, let's say, even if we get to around one hundred billion in a year, say, going from pensions to insurance, in the next five years that's still only 500 billion. We've got across, that still leaves us with a trillion, that's still two thirds of the market we have today. So even those that clearly want to move to buy out, they’re going to have to think quite carefully about when that happens and that sort of transition journey. So there's a quite a long period, potentially, they may still need to be running on those assets, and again, asset managers have a key role to play in that space.

Charlotte Moore: Yes, and to go back to David to pick up on point that Ben made, and that's such a great illustration of how asset managers can work within this scenario. Paul just mentioned run on there. Ben mentioned the challenge of handing over all your assets that you've looked after and you've tried to make sustainable. Do you think that for certain pension schemes that might motivate trustees to move away from buyout and towards run on? Because they want to keep control of their assets and be able to invest in the way they want, and to be able to invest sustainably?

David Brown: I think, in the right scenario there will be cases. I think, if I'm a business backed by a strong covenant that healthy funding position and for some of the wider benefits I touched on earlier in terms of maybe discretionary pension increases and such like. I think there are going to be those opportunities for trustees to continue, but I think it's going to be quite a mixed bag. There'll be many that will continue in their buyout journeys and from my personal view, and it'd be great to get others thoughts on this, but I think it's for the bigger schemes - the billion pound plus schemes that might be more attracted to the run on option.

Charlotte Moore: Well, do you agree with that? Do you think it's that run on? Is really only for big schemes?

Paul Kitson: It's interesting, I think it is true that for bigger schemes, the case is clearer, but we are talking with a number of smaller funds, and in some case very small funds, who have an employer that's very interested in purpose and ESG, and therefore control of the assets is important to them - they want to wait and see. Maybe where the new Government goes, in terms of surplus release, and what that might mean. It's worth remembering that even for a small fund by asset size, that by definition means it's got a small number of members. So actually, the member uplift, if you believe in the story of runoff, and that some of that surplus and benefit can be delivered to the members - it's sort of the same. So that case is still made, and still there. So I think certainly the case is stronger for the bigger funds, but certainly we're seeing a number of small funds too, quite interested in whether it's right for them.

Charlotte Moore: Ok, well, I'm aware we have covered a lot of quite technical and quite dense material in this last 25 minutes or so, and perhaps not everybody is quite as geeky as me, and loves talking about all this stuff. Even though it was a baptism of fire to wrap my head around it, and it took many, many conversations. So, I think we're going to wrap things up from a technicality and denseness point there, and I'm just going to ask each of my members of today's podcast if they can give me the one key takeaway, they would like the listener to have at the front of their brain, at the end of this podcast. Let's start with Ben and then we'll ask Paul, and finally, David. Go on, Ben Grainger, what's your takeaway?

Ben Grainger: We've got some work to do on that still.

Charlotte Moore: Wonderfully succinct, Paul?

Paul Kitson: Yeah, I suppose most of my life is talking to pension funds. So, my takeaway is probably for them, which is: think about where it is that you're going. It's a complex market and understanding your endpoint - and when you might be there - is, I think, the important first step. So that would be my takeaway.

Charlotte Moore: And David?

David Brown: There's always the worry going last, you think your point might have been stolen, but pleasingly mine hasn't… It's also very nice and simple and that is: basically sustainability is not a 'nice to have'. As a trustee, make sustainability-related factors, higher up your priority order and your decision-making criteria when you come to transact, and work with advisors, who that really do understand the ESG agenda. Basically, in short, I think your members will thank you for this in the decades to come.

Charlotte Moore: Great place to end. So, thank you to my three members of this podcast for your excellent insights and your very neat and precise descriptions of really quite technical matters. Listeners, if you want to make sure you never miss an episode, hit the follow button.

Thank you for listening.